Office of Chief Counsel
Internal Revenue Service

memorandum

CC:LM:F:[redacted]:POSTF-124141-02
[redacted]

date: July 9, 2002

to: [redacted], Team Manager
LMSB Group [redacted]

from: Associate Area Counsel, [redacted]
CC:LM:FS:[redacted]

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subject: [redacted]
[redacted] **Contract Termination Payments**

This memorandum responds to your request for assistance dated April 17, 2002, concerning whether payments made by [redacted] to [redacted] to terminate a power supply contract whereby [redacted] was to sell [redacted]% of the output of [redacted] to [redacted] may be deducted by [redacted]. This memorandum should not be cited as precedent.

FACTS

In [redacted], [redacted] and [redacted], now a subsidiary of [redacted], entered into a Power Sale Agreement (PSA) whereby [redacted] agreed to purchase [redacted]% of the output of [redacted] generating unit at [redacted], for [redacted] years. The price of the power was [redacted]% of all costs of construction and operation of [redacted]. A [redacted] amendment to the PSA extended it to [redacted]. In [redacted], [redacted] desired to divest of its ownership in [redacted] and mitigate its future obligations with respect to [redacted]. [redacted] negotiated a sale of [redacted] to [redacted]. [redacted] did not want to assign the [redacted] PSA to [redacted], apparently because it would still be liable under the PSA unless [redacted] consented. [redacted] wanted to terminate the PSA because the price of the power was now over the current market price. [redacted] and [redacted] agreed on an amount which [redacted] would pay for [redacted] to cancel the PSA. The amount was the balance of [redacted]'s [redacted]% share of decommissioning costs and net unit investment costs less [redacted]'s [redacted]% share of the net sale proceeds. Simultaneously, [redacted] and [redacted] negotiated a Power Purchase Agreement (PPA) for [redacted]% of [redacted]'s output at the current market rate.

The cancellation of [redacted]'s PSA with [redacted], the sale of [redacted] to [redacted] by [redacted], and the PPA between [redacted] and [redacted] were conditioned upon each other by the terms of the respective contracts. For example, the [redacted] Amendment to the PSA between [redacted] and [redacted], whereby each parties' rights under the PSA would be terminated, stated as follows:

20201

5. [redacted]

Further, the [redacted] "Whereas" clause to the preamble to the PPA between [redacted] and [redacted] stated as follows:

[redacted]

The termination in the Whereas clause refers to the PSA between [redacted] and [redacted]. The closing of the sale refers to the sale of [redacted] to [redacted] by [redacted]. Seller refers to [redacted], the seller of power to [redacted]. The Company refers to [redacted].

The transactions were described as follows by [redacted] in its Form 10Q for [redacted], filed with the Securites and Exchange Commission:

[redacted]

The [redacted] Amendment to the PSA was entered into by [redacted] and [redacted] on [redacted]. On the same date, the PPA between [redacted] and [redacted] and the Purchase and Sales agreement between [redacted] and [redacted] for [redacted] were entered into. The actual sale of [redacted] took place on [redacted]. A total of $[redacted] was paid by [redacted] to [redacted] to terminate the PSA. The current audit cycle consists of [redacted] [redacted] and [redacted] years. [redacted] paid [redacted] $[redacted] in [redacted] and $[redacted] in [redacted] of the total of $[redacted] to terminate the PPA. [redacted] deducted as contract termination payments the $[redacted] on its [redacted] return and the $[redacted] on its [redacted] return. The Audit Team Coordinator has asked whether the payments should be treated as payments to enter into the PPA with [redacted] and should be capitalized.

ANALYSIS

I.R.C. section 162(a) provides, in part, that taxpayers may deduct all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business. Sections 263(a)(1) and (a)(2) provide, in part, that taxpayers may not deduct amounts paid for new buildings or for permanent improvements or betterments made to increase the value of any property. Section 161 clarifies the relationship between deductions allowable under section 162 and capital expenditures under section 263. Section 161 provides that the deductions allowed in Part VI, including section 162, are subject to the exceptions set forth in Part IX, including section 263. Thus, the capitalization rules of section 263 take precedence over the rules for deductions under section 162. See also, Commissioner v. Idaho Power Co., 418 U.S. 1(1974).

In the instant case, the payments by [redacted] to terminate the PSA with [redacted] must be captalized because they were part of an integrated plan whereby [redacted] ended up with the PPA with [redacted] for the same [redacted]% output of [redacted] but at market rates. However, the issue is not free from doubt because there is no case directly on point. The facts in [redacted] place this case somewhere in the middle between two extremes. On the one extreme, payments made by the purchaser in a supply contract simply to terminate the contract where the purchaser does not enter into a subsequent contract with the seller are considered deductible termination payments. Stuart Co. v. Commissioner, 195 F.2d 176 (9th Cir. 1952), aff'g T.C. Memo. para. 50,171 (1950) (taxpayer who found cheaper alternative source of vitamin supplements allowed to deduct payments to supplier to cancel supply contract). The result in Stuart is consistent with the numerous cases and revenue rulings which hold that a lessee may deduct under section 162 payments to a lessor to terminate a lease where the lessee does not enter into a new lease with the lessor. See, e.g., Cassatt v. Commissioner, 137 F.2d 745, 748-749 (3d Cir. 1943), aff'g 47 B.T.A. 400 (1942); Rev. Rul. 69-511, 1969-2 C.B. 24. The rationale for the holdings in the many lease cases is that payments to terminate a lease "are not made to produce future income but are costs incurred and damages paid in order to be released from an existing unprofitable arrangement". U.S. Bancorp v. Commissioner, 111 T.C. 23 (1998). On the other extreme, where the termination of one lease is immediately followed by the entry into a second lease with the same lessor covering the same property, the unamortized costs of the first lease are not deductible in the year the first lease is terminated, but rather must be amortized over the life of the second lease. Pig & Whistle Co. v. Commissioner, 9 B.T.A. 668 (1927); Phil Gluckstern's, Inc. v. Commissioner, T.C. Memo. 1956-9.

In the middle of the two extremes is a situation where the purchaser in the supply contract makes payments to terminate the contract and enter into a new, more favorable, contract with the supplier, for a similar but not identical product. This situation occurred in U.S. Bancorp, 111 T.C. 23, where a bank holding company leased a mainframe computer from a finance corporation for a 5 year term. Less than a year later, the bank determined that the computer was inadequate for its needs and entered into a rollover agreement with the finance company whereby the bank would finance a replacement computer with the finance company for a $2.5 million charge. The replacement computer would also be leased for a 5 year term. The Tax Court held that the $2.5 million rollover charge had to be capitalized and amortized over the 5-year term of the second lease. The Court found significant the integrated nature of the agreements and transactions by which the termination of the first lease was expressly conditioned on the bank's entering into a new lease with the finance company.

The Commissioner in U.S. Bancorp relied on Pig & Whistle Co., 9 B.T.A. 668, and Phil Gluckstern's, Inc., T.C. Memo. 1956-9, for authority. The Tax Court in U.S. Bancorp found that the integrated nature of the first and second leases in these two cases supported its conclusion requiring capitalization of the rollover charge. The Court also found that Great W. Power Co. v. Commissioner, 297 U.S. 543, 546-547 (1936), was instructive in illustrating the distinction between the two extremes of a charge for a simple termination and a charge for a termination immediately followed by a modified contract with the same party involving the same property. In Great W. Power, Co., the taxpayer called a bond at 105 plus accrued interest. Under the terms of the bond issue, the bondholders had the option of receiving series B bonds of equal face value, plus 5 percent in cash. The question before the Court was the deductibility of the unamortized discount and expenses associated with the first bond issue plus the premiums and other expenses associated with the call of the first issue and the bond exchange. The Commissioner had conceded that any expenses allocable to the bonds redeemed for cash were deductible. The Supreme Court held that the remaining amounts had to be capitalized over the life of the new bonds. Great W. Power Co., 297 U.S. at 546-547.

In U.S.Bancorp, the second lease was with the same lessor but the subject property was not identical. The other possible middle ground between the two extremes of simple termination and rollover of the same property with the same party in a modified contract is where payments are made to terminate a contract with one party in order to enter into a modified contract for the same property with another party. A situation close to this occurred in Darlington-Hartsville Coca-Cola Bottling Company v. United States, 393 F.2d 494 (4th Cir. 1968), aff'g 273 F. Supp. 229 (D.C.S.C. 1967). In Darlington-Hartsville, two Coca-Cola bottling companies were forced to buy Coca-Cola syrup at inflated prices from a non-productive middleman who had exclusive territorial rights where the bottlers operated and had granted bottling privileges to the two bottlers. Under a negotiated plan, Coca-Cola purchased the stock of the middleman's corporation and liquidated it. The bottlers then reimbursed Coca-Cola for the stock acquisition and in exchange were awarded contracts to obtain syrup directly from Coca-Cola at a price that was not higher than that formerly charged the middleman. The Fourth Circuit agreed with the District Court and held that the payments by the bottlers to eliminate the middleman produced a long term benefit and had to be capitalized. The payments were part of an integrated plan made for the purpose of acquiring new and more favorable franchise bottling contracts.

In [redacted], the payments were made to terminate a power supply contact with the present owner of a generating unit in order to simultaneously enter into a more favorable supply contract for the same power ([redacted]% of [redacted]) with the future owner of unit. [redacted]s termination of the existing PSA with [redacted] was conditioned upon [redacted]'s entering into the new PPA with [redacted]. This case differs from a simple termination because [redacted]'s agreement to the termination of the PSA was conditioned upon [redacted]'s agreement to the new PPA with [redacted]. However, this case also differs from the situation on the other extreme, because the new PPA was with a third party and not the party to the contract being terminated. Thus, the question that must be answered is whether this case is more similar to the modification of a contract than to the simple termination. In U.S. Bancorp, the Tax Court found that the rollover charge incurred by the bank in order to terminate a lease for a computer system and enter into a new lease for different computer equipment had to be capitalized because of the integrated nature of the agreements and transactions. The Court stated that it was also informed by the reasoning in Pig & Whistle Co., and Phil Gluckstern's, Inc. In Pig & Whistle Co., the Board of Tax Appeals also focussed on the interrelationship between the two leases in finding that the lessee's unextinguished cost of acquiring the first lease must be capitalized into the second lease when the lessee and the lessor terminated the first lease and entered into the second lease. Pig & Whistle Co., 9 B.T.A. 668 (1927). The Tax Court in Phil Gluckstern's, Inc., T.C.Memo. 1956-9, followed the reasoning in Pig & Whistle Co.

[redacted] is similar to U.S. Bancorp, Pig & Whistle Co., and Phil Gluckstern's, Inc., in that the PSA with [redacted] was terminated and the PPA with [redacted] entered into as part of an integrated series of agreements and transactions. The termination of the PSA by [redacted] was expressly conditioned upon [redacted] entering into the PPA with [redacted]. [redacted] replaced a supply contract at above the current market rate with a supply contract at the current market rate for the identical product: [redacted]% of the output of [redacted]. The fact that the new supply contract was with a different party should not change the result. In Darlington-Hartsville Coca-Cola Bottling Company, 393 F.2d 494, capitalization was required even though the payments by the bottlers in order to enter into syrup supply contracts with Coca-Cola ultimately were for the benefit of the non-productive middleman.

CONCLUSION

The payments by [redacted] to [redacted] to terminate the PSA should be capitalized and amortized over the life of the PPA with [redacted] because the payments were made as part of an integrated group of agreements and transactions whereby the PSA with [redacted] was terminated and the PPA with [redacted] was entered into.

This writing may contain privileged information. Any unauthorized disclosure of this writing may have an adverse affect on privileges, such as the attorney client privilege. If disclosure becomes necessary, please contact this office for our views. If we can be of any further assistance, please contact the undersigned at [redacted].

[redacted]
Associate Area Counsel (LMSB)